

Congress of the United States

House of Representatives

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Social Security and Privatization REALITY CHECK:

Fifth in a Series

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**Leading Economist Predicts
Investors Will Likely Lose Money with a Private Account**

Dear Colleague:

The attached article reports on Yale finance economist Robert J. Shiller, most notable for predicting the recent stock market bubble and burst, who analyzed whether retirees would do better if Congress replaces guaranteed benefits from Social Security with the private accounts President Bush has proposed. The study is available at www.irrationalexuberance.com.

Professor Shiller studied the likely rate of return for private accounts and whether they would gain enough to pay the “privatization tax” proposed by the president and still have money left over for the investors.

Shiller found that 71 percent of the time accounts will lose money. That is, more money would be deducted from their monthly Social Security checks to pay the privatization tax than they had in their accounts when they retired – leaving them in the hole.

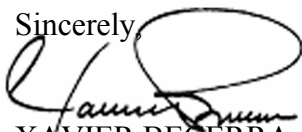
(The privatization tax forces private accounts holders to repay the Social Security Trust Fund for the diversion of funds to their individual accounts. You only gain if your private account earns enough money to make up for the privatization tax. To do so, it must beat a rate of return of 3 percent above inflation.)

Shiller’s finding is based on projections of stock market performance that are in line with those of leading Wall Street professionals, who believe stock returns are likely to be somewhat lower in the future than they have been in the past. Shiller modeled the results for investors whose retirement money is invested in “life-cycle” accounts, which would shift investments from stocks to bonds as a worker ages. President Bush has proposed that all money be automatically invested in these accounts unless a worker actively chooses another option, likely taking on more risk if they do.

Even under the optimistic stock market scenario that the president and privatization supporters have been predicting, Schiller found that, 32 percent of the time, workers would lose money on the account.

Given the probable outcomes that leave workers with little or nothing left in their accounts after paying the privatization tax, **it is extremely doubtful that private accounts would be able to make up for the additional, mandatory cuts that accompany privatization**, which would reduce Social Security benefits by more than 40 percent for future workers.

Sincerely,



XAVIER BECERRA
Member of Congress

The Washington Post

Retirement Accounts Questioned

Paper Challenges Expected Benefits

By Jonathan Weisman

Washington Post Staff Writer

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Nearly three-quarters of workers who opt for Social Security personal accounts under President Bush's "default" investment option are likely to earn less in benefits than those who stay with the traditional Social Security system, a prominent finance economist has concluded.

A new paper by Yale University economist Robert J. Shiller found that under Bush's default "life-cycle accounts," which shift assets from stocks to bonds over a worker's lifetime, nearly a third of workers would bring in less in benefits than if they remained in the traditional system. That analysis is based on historical rates of return in the United States. Using global rates of return, which Shiller says more closely track future conditions, life-cycle portfolios could be expected to fall short of the traditional system's returns 71 percent of the time.

Both the White House and the Social Security Administration have relied on historical returns in estimating the earnings of proposed personal investment accounts. Shiller used 91 computer simulations to analyze the past performance of stocks and bonds in a variety of portfolios. He measured the returns in 44-year increments, beginning in 1871, to approximate a worker's lifetime contributions to personal accounts.

The results "showed a disappointing outlook for investors in the personal accounts relative to the rhetoric of their promoters," concluded Shiller, a leading researcher in stock market volatility who gained fame in the late 1990s for his warnings of a stock market bubble.

Shiller's paper -- to be posted on his Web site, IrrationalExuberance.com -- is adding to research that suggests the White House has been overly optimistic in its assumptions about personal investment accounts. A recent paper by Goldman Sachs economists said the White House's anticipated 4.6 percent rate of return above inflation could be nearly 2 percentage points too high.

Even some supporters of the accounts say Bush has to change his proposal if investors are to turn a profit. Under the Bush proposal, workers would be better off choosing private accounts only if those accounts earned annual returns that exceed inflation by 3 percent.

"I'm one of these people who maintain the 3 percent rate is too high a trade-off," said Jeremy J. Siegel, a finance professor at the University of Pennsylvania's Wharton School and a longtime advocate of stock investing. "You can't get 3 percent in the market anymore."

Trent Duffy, a White House spokesman, said the administration is not contemplating changes to the proposal at this point.

"We're confident returns on the market will be well in excess of what we need to make the program work well for seniors," he said.

Life-cycle accounts were a response to critics who charged that stock market investments would be too risky for Social Security. But according to Shiller's analysis, that conservative investment strategy appears to carry a risk of its own: a paltry rate of return.

Shiller is "documenting what's well known, that bond returns have just been terrible," said Kevin A. Hassett, director of economic policy studies at the American Enterprise Institute and a supporter of personal accounts. "If we are excessively conservative, we will really be hurting workers."

Under the Bush plan, workers ultimately would be able to invest 4 percent of their income subject to Social Security taxes in their choice of stock and bond funds. At age 47, workers who had chosen private accounts would automatically be shifted to a life-cycle portfolio, unless they and their spouse specifically opt out with a waiver acknowledging awareness of higher risk.

When workers with private accounts retire, the Bush system would subtract from their traditional Social Security benefit all of the money deposited in the private account, plus 3 percent interest above inflation. That "offset" or "claw-back" equals the amount the White House assumes those deposits would have earned in Treasury bonds had they gone into the Social Security system.

But the 3 percent hurdle appears too high for many to clear, Shiller found, especially with the conservative strategy the administration has embraced. According to U.S. historical rates of return, the life-cycle portfolio fell short of the 3 percent threshold 32 percent of the time, meaning nearly a third of personal account holders would have been better off sticking with the traditional Social Security system.

The median rate of return was 3.4 percent, barely better than the traditional system. Upon retirement, accounts would yield an annuity payment of about \$1,000 a year, "hardly a windfall," Shiller said.

But he also adjusted for what he expects to be lower future rates of investment return by using historic rates of return from international stock and bond markets. Those returns "correspond more closely to projections of financial economists and should be emphasized more as the appropriate evaluation of the accounts going forward," Shiller wrote.

The results were not encouraging: The life-cycle portfolio under these adjusted returns lost money compared with the traditional system 71 percent of the time, with a median rate of return of just 2.6 percent, \$2,000 less in annual benefits than those of workers who stick with the traditional system.

"To say that there is a money machine in the stock market, that it can be tapped to yield great wealth without significant risk if one uses life-cycle investment methods, is a big mistake," Shiller concluded.

David C. John, a Social Security analyst at the conservative Heritage Foundation and a supporter of the Bush proposal, said Shiller's downward adjustment for lower future earnings is not supported by other studies, which find little correlation between economic growth and stock market returns. Using international markets as a benchmark for future returns is not fair, he added.

"He's bringing the U.S. [financial] market, essentially the most vibrant in the world, down to the level of stock markets in South America, Asia and various parts of Europe," John said. "I frankly find this study to be a stacked deck."

But Hassett, another supporter of private accounts, called the paper "a very thorough and interesting piece." The White House's response should not be to dismiss the paper's conclusions but to rethink the life-cycle portfolios or lower the 3 percent threshold, Hassett said. The latter is an action administration economists are already considering, he added.